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SUBJECT: UKRAINE: POLITICS AND MONEY BEHIND GRAIN EXPORT RESTRICTIONS

REF: A) KYIV 1522, B) KYIV 1422

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¶1. (SBU) Summary: Fear of rising bread prices was the driving force behind the GOU's decision to reintroduce grain export restrictions as of July 1. Bread prices are very politically sensitive in Ukraine, and a number of government officials also have a financial stake in the quotas through business interests that rely on cheap grains. The GOU is therefore unlikely to significantly revise the export restrictions before the September elections. Farmers will suffer more than the grain trading companies in this incarnation of export restrictions, as advance warning allowed grain traders to delay their purchasing, yet Ukrainian farmers have not managed a vigorous or effective protest. With high world prices for grain expected to persist, Ukraine needs to develop a more market-friendly policy in its quest to keep bread prices low. The GOU has some options: it could move towards direct price subsidies and develop a grain futures market; a special intervention fund could also be helpful. End Summary.

¶2. (U) As reported reftel A, Cabinet of Ministers Resolution No. 844 reinstated limitations on grain exports as of July 1, after a drought in southern Ukraine reduced the 2007 grain harvest. The GOU has authorized an export quota of only 3,000 tons, a mere token amount, for each of the following types of grain: wheat (and a wheat/rye mix), barley, corn, and rye.

The Politics of Bread

¶3. (U) The GOU cited concerns for rising bread prices in defending the reintroduction of export restrictions, although bread prices had remained rather stable (see ref A). Yet because domestic wheat prices were significantly lower than world prices -- in June wheat sold for approximately $170/ton in Ukraine compared to $300/ton for wheat futures in the United States -- wheat prices, and eventually bread prices, were destined to rise in the absence of a government intervention. Analysts from the Ukrainian Grain Association and the Ukrainian Agrarian Confederation said they lacked firm data but estimated that in the absence of export quotas, prices would rise anywhere from 8% to 40%

¶4. (U) Rising bread prices have become a kind of bogeyman in Ukrainian politics. In 2003 former Deputy Prime Minister Leonid Kozachenko was put under criminal investigation for lifting grain export quotas after a low harvest. Current Deputy Prime Minister

Viktor Slauta and Minister of Agriculture Yuriy Melnyk found themselves in a similar position when, on June 6, Prime Minister Yanukovich publicly threatened their dismissal should bread prices rise (see also reftel A). The GOU is clearly keeping a close eye on bread prices in the run-up to parliamentary elections, scheduled for September 30.

Political Connections

¶5. (SBU) Many government officials also have a financial interest in keeping bread prices low. According to Korrespondent, a Ukrainian weekly newspaper, 26 MPs from the Party of Regions alone own a stake in Ukrainian bakeries. For example, MPs Volodymyr Ivanov and Vasil Khmelnitsky, both recent converts to the Party of Regions, control Khleb Kieva, one of the larger regional bakeries. Deputy Prime Minister Slauta has long had ties to Khlib Ukrainy, the state-owned bread giant; he ran their office in Donetsk during the mid-1990s. Minister of Agriculture Melnyk, meanwhile, is a member of the board of the Poultry Union of Ukraine, which benefits from low feed grain prices. Grain producers, exporters, and other businesses that would benefit from higher grain prices, meanwhile, lack these significant political connections. Representatives from both the Ukrainian Grain Association and Agrarian Confederation told Econoff on July 4 that the political connections of the bakery industry had played a key role in grain policy, although they declined to name specific government officials benefiting financially from the quotas.

Farmers to be Hit Hard

¶6. (U) Analysts agree that this time the restrictions will hit farmers harder than the grain traders, since the traders were given adequate lead-time and adjusted purchasing accordingly. Cargill,

for example, told Econoff that they had purchased next-to-nothing, and would play a game of wait and see. At an American Chamber of Commerce meeting July 16, other traders said their firms would largely follow similar strategies. Deputy Agricultural Minister Yuriy Luzan said on July 11 that farmers had only half the funds necessary to carry out harvesting and sowing campaigns, which generally occur in August. Additionally, price uncertainty makes it difficult for farmers to plan in advance or invest in improvements that would increase their yield. Exporters have said they expect most farmers to hold onto their stocks until August or September.

¶7. (SBU) Despite this gloomy state of affairs, farmers have not voiced strong opposition to the export restrictions. Although they are well below international levels, domestic prices are actually higher than they were a few years back, and many farmers are therefore still in the black. Traders told us this means many farmers are satisfied to make a profit, even if it is less than they might earn if they could have exported. Farmers are also hesitant to rock the boat for fear of upsetting their relationship with the government, including subsidies in some cases. German Embassy Agricultural Attache Stefan Kresse commented that some of the larger agricultural producers, anxious to swallow up some smaller enterprises, actually appeared to be supportive of the quotas in that they may serve to bankrupt smaller producers.

Long Term Solutions Needed

¶8. (U) At the July 16 American Chamber meeting, all agreed that the GOU was unlikely to eliminate the export restrictions prior to September elections and with the development of biofuels, Ukraine would likely face high world grain prices for some time to come. Several grain trader reps argued that pressuring the GOU in the near term would be counterproductive, although there might be some chance of getting the GOU to back off its export bans on feed grains, which have no impact on bread prices. (Note: Minister of Agrarian Policy Melnyk told the press July 20 he expected the export ban would be lifted October 1, without specifying whether this would be a full or partial lifting of the ban.)

¶9. (U) Bunge and Cargill reps suggested a mechanism whereby exporters could sell 1 million tons of grain to a reserve or intervention fund at a fixed price for every 4-5 million tons they were allowed to export. Dmitriy Gorshunov, country manager at Bunge Ukraine, noted that for example that Russia uses direct subsidies and already has an intervention fund of 1.5 million tons in place. Econ Counselor suggested to the group we needed to develop alternative policy mechanisms to suggest to the GOU for the longer term, such as futures markets or direct payments to the needy, that would be more market-friendly and cheaper than export controls. The group agreed to draft policy proposals.

¶10. (SBU) Comment: Ukraine has reflexively used export restrictions as its "go-to" method for restraining rising grain prices. While this policy works in the short term, it places high costs on the economy. The differential between domestic prices and world prices will be hard to sustain in the long run, so the GOU needs to develop a more market-friendly and less trade-distorting mechanism to achieve its goals.

TAYLOR